No. 04-55665

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

T. JEFFREY SIMPSON, on behalf of himself and all others similarly situated,

Plaintiff,

and

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM,

Plaintiff - Appellant,

v.

HOMESTORE.COM, INC.; et al.,

Defendants - Appellees.

On Appeal from the United States District Court
for the Central District of California

REPLY BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE, IN SUPPORT OF POSITIONS THAT FAVOR APPELLANT

GIOVANNI P. PREZIOSO
General Counsel

JACOB H. STILLMAN
Solicitor

KATHARINE B. GRESHAM
Assistant General Counsel

MICHAEL L. POST
Senior Counsel

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
(202) 942-0921 (Post)

Of Counsel
MEYER EISENBERG
Deputy General Counsel

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Statutes and Rules — Page

Securities Act of 1933, 15 U.S.C. 77a, et. seq.:

Securities Exchange Act of 1934, 15 U.S.C. 78a, et seq.:

Miscellaneous

The Securities and Exchange Commission, which is participating in this appeal as *amicus curiae*, submits this reply brief to address issues raised in the briefs of the defendants and the *amicus curiae* briefs supporting them. In our initial brief, we addressed the appropriate test for finding a defendant to be a primary violator rather than an aider and abettor in a scheme to defraud under Rule 10b-5(a).

As explained in our initial brief, this case involves allegations that a public company and its business partners engaged in a scheme to defraud in which they committed the deceptive act of engaging in transactions whose principal purpose and effect was to create a false appearance of corporate revenues. As we noted, this situation has arisen in a number of recent cases involving schemes to inflate the revenues of internet companies, as well as other types of schemes to misrepresent the financial condition of publicly traded companies. Such schemes harm the integrity of the nation's securities markets and undermine the confidence of public investors.

1. Conduct Covered by Section 10(b) and Rule 10b-5(a)

Defendants and their *amici* incorrectly interpret Supreme Court cases as holding that deceptive conduct under Section 10(b) is limited to conduct that involves material misstatements or omissions, and does not include other deceptive acts. The principal support they offer for this interpretation is the

following statement in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994):

> As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act. See Santa Fe Industries [v. Green], 430 U.S. at 473 ("language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception"); Ernst & Ernst [v. Hochfelder], 425 U.S. at 214 ("When a statute speaks so specifically in terms of manipulation and deception . . . , we are quite unwilling to extend the scope of the statute").

511 U.S. at 177. According to defendants and their *amici*, this statement is a holding by the Supreme Court on the interpretation of the "manipulative or deceptive device or contrivance" language of Section 10(b), with "manipulative act" the conduct covered by the manipulative component and "misstatement (or omission)" the conduct covered by the deceptive component. Thus, in their view, "deceptive" covers only conduct that deceives by false statement or misleading omission.

The Central Bank statement, however, is *dictum*, as it was not essential to the determination of the case, which concerned "the existence and scope of the § 10(b) aiding and abetting action" (511 U.S. at 170).[1] It was not necessary for the

[1] See Export Group v. Reef Industries, Inc., 54 F.3d 1466, 1472 (9th Cir. 1995) (adopting Black's Law Dictionary definition of *dicta* as "'[e]xpressions in the court's opinion which go beyond the facts before the court'"); Black's Law Dictionary 465 (7th ed. 1999) (defining *dictum* as "[a] court's stating of a legal principle more broadly than is necessary to decide the case").

Supreme Court, in deciding that aiding and abetting is not covered by the statutory language, to determine the full extent of deceptive conduct covered by Section 10(b) – an issue that was not raised by the case or briefed by the parties.

It is also inconceivable that the Court would make a pronouncement on such an important matter of statutory construction without explanation. Instead, as is apparent from the citations to Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977), and Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), and the accompanying parentheticals, the sentence is best explained as an unfortunate choice of words to paraphrase the statutory language. The parentheticals refer to both the statutory terms "manipulation" and "deception" and do not purport to explain the scope of conduct encompassed by those terms.

Indeed, both Santa Fe and Hochfelder contain language showing that deceptive conduct under Section 10(b) and Rule 10b-5 can include more than misrepresentations. In Santa Fe, the Court observed in discussing case law on what constitutes deceptive conduct: "[T]he cases do not support the proposition . . . that a breach of fiduciary duty by majority stockholders, without any *deception, misrepresentation, or nondisclosure,* violates the statute and the Rule." 430 U.S. at 476 (emphasis supplied). In other words, deceptive conduct can be

something other than misrepresentation or nondisclosure.[2] In Hochfelder, the Court observed that the language of subsections (b) and (c) of Rule 10b-5 could be read as "proscribing . . . any type of material misstatement or omission, and any course of conduct, that has the effect of defrauding investors . . . ." 425 U.S. at 212. Again, the Court recognized that the Rule covers conduct beyond misstatements and omissions. (See also the Commission's initial brief at pp. 13-14, 18-19 n.6 for other cases and authorities showing that the statute and rule cover conduct beyond the making of misstatements and omissions.)

Amicus American Institute of Certified Public Accountants acknowledges that Rule 10b-5(a) focuses on "actions rather than statements," but asserts that the provision "should be understood simply as implementing Section 10(b)'s prohibition" on "manipulative conduct." AICPA Brief at 20. No support is offered for this statement, and the plain language of neither Section 10(b) nor Rule

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[2] *Amicus* American Institute of Certified Public Accountants states that in Santa Fe the Court "held that because 'the complaint failed to allege a material misstatement or material failure to disclose,' there was no allegation of 'deceptive' conduct within the meaning of Section 10(b)." AICPA Brief at 20, quoting Santa Fe, 430 U.S. at 474. The AICPA attempts to elevate the Court's observation about the complaint into a holding that deceptive conduct under Section 10(b) can only involve misstatements or omissions. In Santa Fe, however, there was no allegation of *any* type of deceptive conduct: investors "were furnished with all relevant information on which to base their decision" (430 U.S. at 474). The Court's holding was that the transaction at issue "if carried out as alleged in the complaint, was neither deceptive nor manipulative and therefore did not violate either § 10(b) of the Act or Rule 10b-5." *Id.*

10b-5(a) suggests such a restrictive intent. Moreover, the Commission interprets Rule 10b-5(a) as covering not only manipulative conduct, but also deceptive conduct, as is apparent from the test proposed by the Commission in this case – that "any person who directly or indirectly engages in a manipulative *or deceptive* act as part of a scheme to defraud can be a primary violator under Section 10(b) and Rule 10b-5(a)." SEC Brief at 16 (emphasis added).

It is important that the narrow view of Section 10(b) urged by the defendants and their *amici* be rejected because it ignores the reality that facts can be misrepresented by conduct as well as words. See SEC Brief at 18-19 & n.6. One who creates a material deception through a false statement can be a primary violator; similarly, one who creates the same material deception through deceptive conduct rather than words can also be a primary violator.

2. Criticism of the Commission's Proposed Tests for Primary Liability and Reliance

a. Primary Liability

Commission's Test: Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10(b) and Rule 10b-5(a).

The Commission's test for primary liability is not new, as the defendants suggest, but rather a restatement of existing law as applied to participation in a scheme to defraud. The crux of the test is the requirement that the defendant *himself* engage in a "manipulative or deceptive" act – a requirement that is based

squarely on the language of the statute itself. SEC Brief at 16. The remainder of the test is a combination of (i) language the Supreme Court has found to be synonymous with Section 10(b)'s language, (ii) language from the related antifraud provision in Section 17(a) of the Securities Act of 1933, and (iii) language from Rule 10b-5. See SEC Brief at 12-15. The test is consistent with this Court's statement in Cooper v. Pickett that "Central Bank does not preclude liability based on allegations that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme." 137 F.3d 616, 624 (9th Cir. 1998).

As explained in the Commission's initial brief, the Commission's test provides a meaningful distinction between a primary violator and an aider and abettor and is thus consistent with Central Bank. SEC Brief at 17-18. It is important that the test requires that *each defendant* engage in a "manipulative or deceptive" act; this requirement avoids the danger of extending primary liability to cover activity that is only aiding and abetting. We also note that the Commission's test, together with the application by the courts of the heightened pleading requirements of Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act, will help to weed out frivolous or vexatious

litigation. See Wharf (Holdings) Ltd. v. United Intern. Holdings, Inc., 532 U.S. 588, 598-97 (2001).[3]

None of the defendants or their *amici* presents an argument that would justify rejection of the Commission's test for primary liability in a scheme to defraud. Indeed, given its grounding in the language of the statute and rule, they attack the test by misstating it and explaining why their misstated version amounts to aiding and abetting.

For instance, defendant AOL Time Warner asserts that the Commission defines primary violators as "all who 'directly or indirectly' engage in *any* 'part of' a 'scheme to defraud.'" AOL Brief at 42 (emphasis in original). AOL then argues that there is no meaningful difference between substantial assistance in the primary violation (*i.e.*, aiding and abetting) and "'indirect engagement as part of a scheme.'" *Id.* The Commission's actual test, however, covers "any person who directly or indirectly *engages in a manipulative or deceptive act* as part of a scheme to defraud." The test thus distinguishes covered conduct from mere aiding and abetting, which does not require a person to engage in a manipulative or deceptive act. The test also does not cover engaging in "any part" of a scheme to

[3] As noted in our initial brief, we do not believe that, in the context of a scheme to defraud, a test turning on whether a defendant had "substantial participation" in the scheme would be appropriate. See SEC Brief at 16-17 n.3.

defraud; it covers only parts of the scheme that constitute a manipulative or deceptive act within the meaning of Section 10(b). [4]

The defendants and their *amici* also use this tactic of knocking down straw men in their critiques of the Commission's examples of conduct that could constitute a primary violation, particularly the example of "engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues." The AICPA argues that "[c]onduct that, by itself, would not mislead investors is not actionable simply because it has the 'purpose' and 'effect' of helping a third party do so," since such conduct is only aiding and abetting. AICPA Brief at 24. But the Commission's example says nothing about conduct whose purpose and effect is "helping a third party" mislead investors. Rather, it covers conduct whose principal purpose and effect is *creating a false appearance* of revenues – conduct that is *itself* deceptive.

The BMA and AICPA briefs characterize the Commission's test as turning on a distinction between "legitimate and illegitimate" transactions and complain

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[4] Similarly, defendant Keller maintains that the "Commission's new version of 'deception' means that a person who does not make a misstatement can nevertheless be primarily liable if he intentionally commits *an act* with the intention that someone else make a misstatement." Keller Brief at 27 (emphasis added). This reformulation, like AOL's, ignores the test's "manipulative or deceptive" act requirement. Under the Commission's actual test, a person who does not make a misstatement is potentially a primary violator only if he or she engages in some other manipulative or deceptive act within the meaning of Section 10(b).

that such a test is too "ambiguous" or "vague" to provide a workable test for primary liability. BMA Brief at 30; AICPA Brief at 25. The Commission, however, urges no such test. The Commission's initial brief stated that a transaction whose principal purpose and effect is to create a false appearance of revenues is deceptive. The Commission did not suggest that all transactions a plaintiff alleges to be in any way "illegitimate" are deceptive.

Some defendants and *amici* criticize the Commission as proposing a distinction between a primary violation and aiding and abetting that turns on the actor's state of mind. See Colburn Brief at 28; see also Cendant Brief at 36 (arguing a transaction could be the basis for liability based on a party's principal purpose) and BMA Brief at 30. The Colburn brief, which is illustrative of this argument, recounts the Commission's contrasting hypothetical examples:

> [1] a third party that "engages with the corporation in a transaction whose principal purpose and effect is to create a false appearance of revenues, intending to deceive investors in the corporation's stock, . . . may be a primary violator", [2] while a third party that "enters into a legitimate transaction with a corporation, knowing that the corporation will overstate the revenue generated by the transaction, . . . is at most an aider and abettor."

Colburn Brief at 28. The Colburn brief then states that "the *conduct* of the third party – entering into the underlying business transaction – is the same in both [examples]," and the only difference is that in the first example, "the third party not only knows how the corporation will account for the transaction but

affirmatively intends that result." *Id.* at 29 (emphasis in original). This argument, however, ignores the fact that the first example involves a transaction whose principal purpose and effect is to create *a false appearance* of fact and the second does not. To engage in one or the other of the hypothetical transactions is not the same conduct, and the distinction between them therefore does not turn on the actor's state of mind. [5]

Finally, the AICPA rejects primary liability for deceptive transactions that do not themselves involve false statements on the ground that such transactions have no effect on the market unless a third party reports them fraudulently. AICPA Brief at 25-26. In the AICPA's view, "a primary defendant must be culpable – in the sense of actually defrauding investors or the market – based solely on its own actions, rather than as a result of the conduct or statements of someone else." *Id.* The AICPA's view of primary liability ignores the plain language of Section 10(b) and Rule 10b-5, both of which include the phrase "directly or indirectly." A defendant indirectly defrauds the market if he or she

[5] L90 believes that the Commission's contrasting examples suggest that its conduct would be covered "just because *Homestore's* 'principal purpose' was to misstate revenue," and that the test would thus make Rule 10b-5 liability turn on the intent of a defendant's "counter-party," rather than on the defendant's own intent. L90 Brief at 30 (emphasis added). This critique misstates the Commission's position. The *transaction's* principal purpose and effect must be to create a false appearance of revenues. Each defendant, of course, must also have the requisite scienter.

engages with an issuer of securities in a transaction whose principal purpose and effect is to create a false appearance of revenues that will be reported falsely by the issuer. [6]

The AICPA's argument is also foreclosed by this Court's decision in Cooper v. Pickett, 137 F.3d at 616. There, corporate officials provided false information to securities analysts with the intent that the analysts would then make statements to the securities markets based on that false information. (To use the AICPA's formulation, the investors were not defrauded "based solely on the [corporate officials'] own actions," but "as a result of the conduct or statements of [the analysts].") The Court ruled that Central Bank did not bar the plaintiffs' claims because the plaintiffs "are asserting that [defendants], through false statements to analysts, and those analysts, by issuing reports based on statements they knew were false, together engaged in a scheme to defraud the shareholder." 137 F.3d at 625. If the AICPA's approach were correct, then the complaint against the corporate officials would have been dismissed because their deception

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[6] In Central Bank, the Supreme Court rejected the suggestion that the statutory "directly or indirectly" language could be used to support aiding and abetting liability under Section 10(b). 511 U.S. at 176. The Court stated: "The problem, of course, is that aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do." *Id.* This statement indicates that a secondary actor in a scheme to defraud can be primarily liable if he or she indirectly engages in a manipulative or deceptive act.

was not communicated to the market until the analysts made their subsequent statements.

Acceptance of the approach of defendants and their *amici* would undermine the intent of Section 10(b) to protect investors against fraud and to ensure honest markets. If two companies together make a false statement about the revenues of one of them, both companies undisputedly could be primarily liable for securities fraud. If they together achieve the same deception by engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues, but only one of them makes a misstatement about the revenues, investors would be misled by the deceptive conduct of both, and both can be primarily liable.

b. Reliance

> Commission's Test: The reliance requirement is satisfied where a plaintiff relies on a material deception flowing from a defendant's deceptive act, even though the conduct of other participants in the fraudulent scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction.

The Commission's reliance test is derived from basic legal principles concerning causation as applied to participation in a scheme to defraud investors in the securities markets. See SEC Brief at 21-23. The test is met where the plaintiff relies on a material deception that flows from a deceptive act committed by the defendant, even though the conduct of others is a subsequent link in the chain of causation that injects the material deception into the securities markets.

As explained in greater detail below, the defendants and their *amici* mischaracterize the Commission's test and then criticize the mischaracterized test as eviscerating the reliance requirement. Their arguments ignore the crux of the Commission's test, which requires the *material deception* created by the defendant to flow through the subsequent actor's actions; the test does not just require the subsequent actor's actions to flow or follow from the defendant's *actions*.

The AICPA, for example, argues that the Commission's "notion that a plaintiff who relies on a misstatement thereby relies on the actions of every party who played some antecedent role in helping that misstatement come into life is precisely what Central Bank rejected." AICPA Brief at 23; see also AOL Brief at 46 (arguing that the Commission's test allows reliance on a statement that "in any way 'flow[ed] from' the scheme in which the defendants allegedly took part"). Under the Commission's actual test, however, the defendant must himself commit a deceptive act, not simply have "some antecedent role in helping [a] misstatement come into life." The material deception created by the defendant must then flow through a misstatement made by a subsequent actor that is the natural consequence of the defendant's initial deceptive act. Thus, when the plaintiff engages in a securities transaction, the plaintiff relies on a material deception initially created by the defendant.

In addition to mischaracterizing the test, the defendants and their *amici* argue that the requirement that a plaintiff plead and prove reliance as to each defendant means that a plaintiff must rely on each defendant "directly." BMA Brief at 12. [7] They base this argument on the Supreme Court's statement in Central Bank that "[a] plaintiff must show reliance on the defendant's misstatement or omission to recover under 10b-5." 511 U.S. at 180. Violations of Section 10(b) and Rule 10b-5, however, can be accomplished indirectly, as explained supra p. 10. There is no suggestion in Central Bank that reliance on a defendant's actions cannot be indirect – as on a material deception flowing through the subsequent actions of others.

The defendants and their *amici* also argue that the Commission's test is at odds with the Supreme Court's statement in Central Bank that the argument made by the plaintiffs in that case "'would impose 10b-5 aiding and abetting liability when at least one element critical for recovery under 10b-5 is absent: reliance.'" 511 U.S. at 180. According to defendants and their *amici*, allegations of mere aiding and abetting would meet the Commission's reliance test, and the test is

[7] The BMA brief argues that "[b]ecause it is only Homestore's public statements to the marketplace that connect investors to the alleged 'scheme,' Plaintiff cannot plead or prove that investors relied on the Business Defendants at all." BMA Brief at 23. See also AICPA Brief at 22-23; L90 Brief at 30-31; Keller Brief at 22.

therefore foreclosed by Central Bank. See AICPA Brief at 22; Colburn Brief at 43; AOL Brief at 46.

To place the Supreme Court's statement in context, however, it is significant that the Court went on to say in the same paragraph that "[w]ere we to allow the aiding and abetting action proposed *in this case*, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions." 511 U.S. at 180 (emphasis added). In Central Bank, the defendant bank had been the indenture trustee for a defaulted bond issue, and had not created any misrepresentations, but had failed to update the appraisal for land securing the bonds. Before concluding that summary judgment for the bank was proper, the Court noted that the plaintiffs "concede[d] that Central Bank did not commit a manipulative or deceptive act within the meaning of § 10(b)." *Id.* at 191. Thus, the plaintiffs in that case, as the Supreme Court recognized, could not be said to have relied on any deception created by the bank. The Commission's reliance test begins with the requirement that the defendant engage in a deceptive act, and requires the plaintiff to have relied on the material deception created by the defendant. Thus, contrary to the contentions of defendants and their *amici*, the allegations in Central Bank would not have met the Commission's proposed test, and there is therefore no tension between that test and Central Bank.

It is important that the Court reject the approach of defendants and their *amici* to reliance, as it would only invite gamesmanship on the part of wrongdoers. Defendants and their *amici* essentially argue for a rule precluding reliance on parties that are one or more causal steps removed from the injured party. But under such a rule, wrongdoers could structure their conduct so as to engage only in materially deceptive activity that is at least one causal step away from false statements to investors and the market, and thereby escape liability in a private action. This would be the case even though their actions caused the same injury to investors and the same deleterious effects on the market as if they had committed fraud through their own false statements. [8]

CONCLUSION

For the foregoing reasons, and for the reasons set forth in the Commission's initial *amicus curiae* brief, the Court should hold that any person who has the requisite scienter can be liable as a primary violator of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(a) thereunder when he or she,

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[8] The BMA *amicus* brief argues that the "in connection with" requirement under the statute and rule is not satisfied here, basing that argument on SEC v. Zandford, 535 U.S. 813 (2002). BMA Brief at 16-21. The Court in Zandford stated that to satisfy the requirement "it is enough that the scheme to defraud and the sale of securities coincide." 535 U.S. at 822. Where, as part of a scheme to misrepresent a company's true financial results, a defendant engages in a transaction whose principal purpose and effect is to create a false appearance of revenues, and where that effect continues at the time of purchases and sales of the company's stock, the fraud and the securities transactions *do* coincide.

directly or indirectly, engages in a manipulative or deceptive act as part of a scheme to defraud; that engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues constitutes such a deceptive act; and that the reliance requirement in private actions is satisfied where a plaintiff relies on a material deception flowing from a defendant's deceptive act, even though the conduct of other participants in the fraudulent scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction.

Respectfully submitted,

GIOVANNI P. PREZIOSO
General Counsel

JACOB H. STILLMAN
Solicitor

KATHARINE B. GRESHAM
Assistant General Counsel

_____

MICHAEL L. POST
Senior Counsel

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0606
(202) 942-0921 (Post)

Of Counsel
MEYER EISENBERG
Deputy General Counsel

February 2005

A D D E N D U M

TABLE OF CONTENTS

FRAUDULENT INTERSTATE TRANSACTIONS

Section 17. [77q] (a) Use of interstate commerce for purpose of fraud or deceit--It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly–

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. * * * *

MANIPULATIVE AND DECEPTIVE DEVICES

Section 10. [78j] It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange-- * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. * * * *

EMPLOYMENT OF MANIPULATIVE AND DECEPTIVE DEVICES

17 C.F.R. 240.10b-5 It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

CERTIFICATE OF SERVICE

I hereby certify that, on this day, I caused an original and four copies of the Motion of the Securities and Exchange Commission for Leave to File *Amicus Curiae* Reply Brief, and the original and fifteen copies of the foregoing reply brief to be sent by overnight delivery to

Cathy Catterson
Clerk of Court
U.S. Court of Appeals for the Ninth Circuit
95 Seventh Street
San Francisco, CA 94103-1526

and a copy of the Commission's motion and two copies of the foregoing reply brief to be sent by overnight delivery to

John B. Quinn, Esq.
Quinn Emanuel Urquhart
Oliver & Hedges
865 South Figueroa Street
Los Angeles, CA 90017

Samuel Kadet, Esq.
Skadden, Arps, Slate, Meagher
& Flom
Four Times Square
New York, NY 10036

F. Whitten Peters, Esq.
Williams & Connolly
725 - 12th Street, NW
Washington, DC 20005

Edward S. Nathan, Esq.
Stern Greenberg & Kilcullen
75 Livingston Avenue
Roseland, NJ 07068

Daniel J. Tyukody, Jr., Esq.
Michael C. Tu, Esq.
Orrick Herrington & Sutcliffe
777 S. Figueroa Street, Suite 3200
Los Angeles, CA 90017

Belinda Lee, Esq.
Latham & Watkins
633 W. Fifth Street, Suite 4000
Los Angeles, CA 90071-2007

Roger C. Spaeder, Esq.
Zuckerman Spaeder Goldstein
Taylor & Kolker
1201 Connecticut Ave., NW
Suite 1200
Washington, D.C. 20036

Paul D. Murphy, Esq.
Murphy Rosen & Cohen
100 Wilshire Boulevard
Suite 700
Santa Monica, CA 90401

Everett C. (Kip) Johnson, Jr., Esq.
Latham & Watkins
555 Eleventh Street, N.W.
Suite 1000
Washington, DC 20004-1304

Eric A. Isaacson, Esq.
Lerach Coughlin Stoia Geller
Rudman & Robbins
401 'B' Street
San Diego, CA 93101

Nancy L. Fineman, Esq.,
Cotchett Pitre Simon &
McCarthy
840 Malcolm Road
San Francisco, CA 94010

David H. Braff, Esq.
Sullivan & Cromwell
125 Broad Street
New York, NY 10004

Jeffrey Speiser, Esq.
Stern & Kilcullen
75 Livingston Ave.
Roseland, NJ 07068

Michael L. Post
Senior Counsel
Securities and Exchange Commission
450 Fifth St., N.W.
Washington, D.C. 20549-0606
(202) 942-0921

February 4, 2005

CERTIFICATE OF COMPLIANCE
Pursuant to Fed. R. App. P. 32(a)(7)(C) and Circuit Rule 32-1
For Case Number 04-55665

I hereby certify that pursuant to Fed. R. App. P. 32(a)(7)(C) and Ninth Circuit Rule 32-1, the attached answering brief is proportionately spaced, has a typeface of 14 points or more, and contains 4,264 words.

_____

Michael L. Post
Senior Counsel
Securities and Exchange Commission
450 Fifth St., N.W.
Washington, D.C. 20549-0606
(202) 942-0921

February 4, 2005